MORNING BRIEFING
September 20, 2012

QE3: A Very Brief History

(1) John Williams told us all about QE3 on 7/23. (2) QE3 boosted bullish sentiment and thinned out the correction camp. (3) Junk thrives in QE3 sunshine. (4) Demand/supply ratio bearish for oil. (5) Open-minded on open-ended. (6) Fed cleverly positioned to get credit for housing recovery. (7) How QE3 could boost earnings. (8) Time for another glass of sangria.

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Strategy. It was only a week ago that the Fed's FOMC formally implemented its latest and most radical version of quantitative easing on September 13. While the details surprised the markets, the concept of an open-ended QE3 was first floated by John Williams, president of the Federal Reserve Bank of San Francisco, in a July 23 interview in the *FT.* He is a voting member of the FOMC.

In the interview, Williams warned of significant downside risks to the US economy from the fiscal cliff, the euro zone crisis, and the global slowdown. He favored QE3 with the Fed buying mortgage-backed securities. He proposed that it be open-ended without specifying how much the Fed would purchase and when the program would end. That's exactly what the Fed implemented last week. (I highlighted this story in our *Morning Briefing* the very same day it appeared in the *FT.*)

Williams floated the idea again in an interview reported in the 8/10 issue of the *San Francisco Chronicle.* When he was asked whether QE3 should be saved to cushion the fall off the cliff early next year, if necessary, he responded: "We want to position the economy to be strong in advance of that. If you are really worried about running out of ammunition, you want to act more aggressively, more quickly and better prepare yourself for that eventuality." (I believe the question was inspired by a conversation I had with the reporter who asked me what I would ask Mr. Williams.)

Boston Fed President Eric Rosengren, who is a non-voting member of the FOMC, seconded Williams' motion for open-ended QE3 in an interview reported in the 8/7 *WSJ.* According to the minutes of the July 31-August 1 FOMC meeting, released yesterday, "Many participants expected that such a [QE] program could provide additional support for the economic recovery both by putting downward pressure on longer-term interest rates and by contributing to easier financial conditions more broadly."

On August 23, I made the following prediction about Fed Chairman Ben Bernanke's next big speech: "I think there's a chance that he might announce during his August 31 speech at Jackson Hole that the Fed will launch an open-ended QE3 program with the hope of turbocharging the economy so that it can leap over the cliff." He didn't do so explicitly, but he certainly set the stage for the FOMC decision on September 13 by expressing his "grave concern" about the unemployment problem.

Now let's turn from this brief history of QE3 to its impact on the markets so far, and its likely impact on the economy and earnings:

1) *Stock Prices & Sentiment.* The S&P 500 is up 4.4% since Bernanke's speech and 1.7% w/w. It was down slightly on Monday and Tuesday, and up slightly yesterday (*Fig. 1*). It is 7.8% above its 200-day moving average (*Fig. 2*). So far, there has been no correction of the QE3 rally.

Interestingly, as Debbie reported yesterday, the latest weekly Investors Intelligence survey shows that the percentage of advisors expecting a correction has plunged from a recent high of 40.9% during the week of May 8 to only 21.3% this past week (*Fig. 3*). The percentage of bulls rose to 54.2% this week, which is on the frothy side for sure. However, the Bull/Bear Ratio rose slightly to 2.21 this week from 2.00 last week. When this ratio gets closer to 3.0%, that's when it will be the time to watch out for significant corrections.

2) *Bond Yields & Spreads.* The 10-year Treasury yield is at 1.73% this morning, up from 1.57% when Bernanke gave his speech (*Fig. 4*). That may seem like a perverse reaction to the latest easing of monetary policy. However, it probably reflects a drop in flight-to-safety purchases of Treasuries, as well as a switch into mortgage-backed securities. There were much more significant backups in this yield when QE1 and QE2 were launched. Not surprisingly, the yield spread between high-yield corporate bonds and the 10-year Treasury narrowed since Bernanke's speech, as it did during QE1 and QE2 (*Fig. 5*).

3) *Oil Prices.* Both QE1 and QE2 were bullish for the price of a barrel of Brent crude (*Fig. 6*). So far, that's not the case for QE3, especially over the past three days, as this price plunged $9.14 to $108.05. That might be because this price has already had a sharp rebound from this year's low of $88.29 on June 21. News this week that the Saudis are willing to increase the oil they supply to their customers must have triggered some profit-taking despite rising tensions in the Persian Gulf.

Yesterday, I wrote that the supply/demand balance in world oil markets is bearish. A few of you sent me emails noting that the data Debbie and I reported showed that world oil demand rose to a record high of 89.7mbd during August (using the 12-month average), actually exceeding the record 88.3mbd in world supply. The levels of these two data series compiled by Oil Market Intelligence rarely add up since they are derived by summing lots of estimates and guestimates. However, the ratio of world demand to world supply does have a reasonably good correlation with the yearly percent change in the price of oil (*Fig. 7*). This ratio started turning bearish during the summer of last year.

4) *Housing.* For quite some time, I've sided with the FOMC's hawks, who have been critical of QE. I wasn't a fan of QE2. I think it backfired, reducing the purchasing power of consumers by boosting food and fuel prices. I wasn't rooting for QE3. There are lots of other critics of the Fed's latest unconventional easing program. However, now that it's a done deal, I'm willing to be open-minded about open-ended QE3.

As I previously noted, Bernanke & Co. were very clever to focus QE3 on purchasing mortgage-backed securities since the housing market was starting to recover without any additional assistance from the Fed. If it continues to do so, they can take credit for it!

Sure enough, the latest data for new and existing home sales and for housing starts all look quite good. Debbie reviews them all below. (We regularly update charts of these and other housing-related series in our *Analyst's Handbook: Real Estate,* which you can load into your MyPage by clicking .) The most current series, available for September, are based on a monthly survey of members of the National Association of Home Builders. Their overall Housing Market Index rose this month to 40, up from 14 a year ago and the best reading since June 2006 (*Fig. 8*). August was a very good month for existing home sales, which jumped 7.8% m/m (*Fig. 9*).

5) *Earnings.* If QE3 boosts US economic growth by giving the housing industry an extra lift, that would be good for earnings. If it weakens the dollar, that would be good for earnings. The JP Morgan trade-weighted dollar index was up as much as 9.3% y/y this year on July 24. It is now flat y/y. As a very

rough rule of thumb for the S&P 500, Joe and I reckon that a 10% increase in the dollar will depress profits from overseas by 20% and total profits by 10%.

I asked Joe to compile a performance derby table for the y/y change in the forward earnings of the S&P 500 sectors and industries. It's hard to discern a pattern confirming that the dollar has much influence on earnings at the sector and industry level. We are sure it does, but there are other factors that influence relative earnings performance as well.

Euro Mess. On July 26th, ECB President Mario Draghi promised to do "whatever it takes" to defend the euro. It may take a lot, especially to keep Spain in the euro zone. The latest data, compiled by our clever consultant Sailesh Radha from original central bank sources, show that non-performing Spanish bank loans rose to a record 9.9% during July (*Fig. 10*). Spanish bank deposits continued to fall sharply in July, down €74.2 billion m/m and €207 billion y/y (*Fig. 11*). The ECB lent Spain €411.7 billion through August, mostly through the LTRO facility (*Fig. 12* and *Fig. 13*). Pour another glass of sangria for Mr. Draghi.

The TARGET2 imbalances continued to worsen in August as capital flowed from the south to the north of the euro zone (*Fig. 14*). Last month, Spain had a record debit balance of €434.4 billion. Italy's debit balance was a record €289.3 billion. Germany's credit balance rose to a record €751.4 billion. The M2 monetary aggregates continued to fall y/y during July in Greece (-15.0%), Spain (-6.8), and Portugal (-6.1 in June). M2 was up in Germany (9.0), France (5.1), and Italy (3.8) (*Fig. 15*).

CALENDARS

US. Thurs: Jobless Claims 373k, Weekly Consumer Comfort Index, Philadelphia Fed -4.0, Leading Indicators 0.0%, Lockhart. **Fri:** Lockhart. (Bloomberg estimates)
Global. Thurs: China Flash M-PMI, Euro Zone Flash M-PMI & NM-PMI 45.5/47.5, Germany Flash M-PMI & NM-PMI 45.2/48.5, UK Retail Sales 3.2% y/y, Japan Machine Tool Orders, Euro Zone Consumer Confidence -24. **Fri:** UK Public Sector Borrowing (pounds) 13.2b, Canada Headline & Core CPI 1.3%/1.6% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues, & Valuation (*link*): Industry analysts were slightly more bullish on S&P 500 companies' 2012 revenue and earnings growth prospects last week, but more bearish on 2013 prospects. They held steady on margins, though. Forward revenues is 1.8% below its record high (September 2008) and 1.0% below its cyclical peak (July). Forward revenues edged down last week from a cyclical high, but forward earnings rose to a record high. Projected revenue growth is 2.5% and 4.0% for 2012 and 2013 (versus 2.4% and 4.2% the prior week). Expected earnings growth: 6.3% and 11.3% (versus 6.2% and 11.4%). The projected profit margin remained 9.5% for 2012, 10.1% for 2013. Ex-Energy, projected 2012 revenue growth rises to 5.6% from 2.5%, earnings growth to 9.2% from 6.3%, margins to 9.9% from 9.5%.

S&P 500 Sectors Earnings, Revenues, & Valuation (*link*): Analysts' forward revenue expectations headed lower last week for seven of the 10 sectors, and forward earnings fell for six. The exceptions: Forward revenue forecasts rose w/w for Consumer Discretionary, Financials, and Telecom. Forward earnings rose w/w for Energy, Health Care, Financials, and Telecom. The 2012 revenue and earnings forecasts increased for Energy, Financials, and Telecom. Forward revenues are at cyclical or record highs for Health Care, Financials, and Telecom and down from cyclical highs for Consumer Discretionary and Financials. Forward earnings rose to a record high for Health Care, to cyclical highs for Financials, and Telecom, and increased for Energy. It's down from recent record highs for Industrials and Tech.

ECONOMIC INDICATORS

Housing Starts (*link*): Single-family starts are showing signs of life. They increased for the fifth time in six months, up 5.5% in August and 13.8% over the period. At 535,000 units (saar), they're the highest since April 2010 and comfortably above the first-half average of 501,700 units. Multi-family starts remain on volatile uptrend, dropping 4.9% after a two-month increase of 17.1%. Single-family permits were little changed at 512,000 units last month; multi-family permits were 3.0% lower at 291,000. An encouraging sign: the NAHB housing market index increased for the fifth straight month (by a total of 66.7%) to 40, the highest level since June 2006. All three components are up considerably compared with last summer.

Existing Home Sales & Prices (*link*): The housing recovery is finding its legs. Existing home sales jumped 7.8% in August (after a 2.3% gain in July) to 4.82mu (saar)--the highest since May 2010. Single-family sales posted the biggest increase since last August (up 8.0%) to a 27-month high of 4.30mu (saar). The number of previously owned single-family homes on the market climbed to 2.21mu; that's a reasonable 6.1 months' supply at the current sales rate (down from its peak of 11.5 months' two years ago). The median price of a single-family home increased 10.2% y/y, the best pace in 6½ years.

Weekly Mortgage Applications (*link*): Mortgage applications were little changed during the week of September 14 after an 11.1% jump the prior week (which partially reversed a five-month slide of 18.8%). Lower mortgage rates have boosted the refinancing index by 12.8% over the past two weeks, after it had contracted 22.5% over the prior five weeks. The new purchase index dropped 3.8% after rising in three of the prior four weeks by 9.7%. It remains in a volatile flat trend, virtually unchanged since mid-2010.

FOCUS ON HOUSING-RELATED INDUSTRIES

Computer & Electronics Retail (*link*): Market-weight-rated Computer & Electronics Retail is the S&P 500's sixth-worst-performing industry ytd, with a decline of 18.8%. It's trading 11% below its falling 200-dma. Forward earnings edged up 0.1% m/m in August, but has been down in 12 of the past 21 months. Analysts expect earnings growth of only 10% in 2012 and 4% in 2013 following an anemic 1% gain in 2011. The P/E of 5.3 is near a record low absolutely, and is at a record low relative to the market (a 59% discount). NERI improved to -5.5% in August from -12.2% in July, but has been positive in only five of the past 20 months. Profit margins should remain low for this intensely competitive industry.

Home Improvement Retail (*link*): This market-weight-rated industry's stock price index is up 31.9% ytd and trading at a record high. NERI was down to -4.4% in August from 6.7% in July and a record high of 55.1% in May. Forward earnings has increased in 37 of the past 40 months; it rose 1.6% m/m in August to its highest since November 2006. Analysts expect earnings growth of 16% in 2012 and 17% in 2013, implying five straight years of double-digit percentage gains. The P/E ratio rose to 15.9 in August from 15.1 in July, and is way up from a three-year low in September (12.5). The industry now trades at a 25% premium to the market.

Homebuilding (*link*): The Homebuilding stock price index has risen 92.9% ytd--the most of all 129 S&P 500 industries--and is up 203% since its October low. Rising home prices and a shrinking shadow inventory of unsold homes are brightening the picture for this market-weight-rated industry. The index is trading 41% above its 200-dma, first among the S&P 500 industries. The industry's forward earnings soared 37.7% m/m in August to a five-year high. Consensus annual forecasts for 2012 and 2013 rose in August too, and analysts expect earnings to turn positive in 2012 after five straight years of losses. NERI was steady at a relatively strong 20.8% in August, and was positive for a seventh month in a row after mostly negative readings since mid-2010.

Household Appliances (*link*): The stock price index for the market-weight-rated Household Appliances industry is up 74.7% ytd, second best among S&P 500 industries. Forward earnings rose 2.4% m/m for its seventh monthly gain in a row, but remains 29.9% below its record high and down 22.4% y/y; both are among the worst readings of the S&P 500 industries. Consensus annual earnings forecasts for 2012 and 2013 moved higher again in August, but analysts expect earnings to decline 3% in 2012 before rising 25% in 2013. NERI tumbled to -12.2% in August from 21.1% in July--negative for the first time in six months. Valuation of 9.5 is up from a record low of 6.0 last September; it's at a historically normal 26% discount relative to the market.

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